Special Issue: The Military-Industrial Complex at Work

I. F. Stone's Weekly

VOL. XII, NO. 15 APRIL 13, 1964 WASHINGTON, D. C. 15 CENTS

The Pentagon and the A.T. & T.: A Long Standing Alliance Against the Public Interest

How the Missile Makers Rob the Government

The missile manufacturers have been robbing the government blind. This, in brief, is the finding of a Senate Government Operations subcommittee. Its report, "Pyramiding of Profits and Costs in the Missile Procurement Program" (*Sen. Rept. 970*) came from a committee chaired by a Southern conservative, McClellan of Arkansas. It bore the signatures of a Republican as far to the right as Mundt of South Dakota and a Democrat as tender to the missile-aviation lobby as Jackson of Washington. The hearings on which this report was based were held two years ago. The long delay in filing it will lead the knowledgeable to suspect prolonged haggling by the Defense Department and the missile makers to cut this and soft-pedal that. Yet, to McClellan's credit, it emerged as one of the most critical studies of the arms business since the Nye committee inquiry in the 30's.

Still the Same Cost Plus Racket

The McClellan investigation showed that 30 years after cost-plus contracts were outlawed in the wake of the Nye revelations, virtually the same methods are still being used, now thinly disguised as "estimated total costs plus fixed fee." The word "fixed" is to be read in a poetic sense. If the estimates weren't high enough to start with, they can be revised upward. The more the contractor charges, the more he makes, since the fee is a fixed percentage of the whole. In addition, thanks to a new wrinkle in missile procurement, the less the contractor does, the more money he makes. The new practice of making one producer the prime contractor for a whole "weapons system" enables him to pyramid already padded profits.

This is how it worked in making the Nike missile, "by far the largest program for Army ordnance." Each Nike system comprised four major sub-systems: electronic, aeronautical, mechanical and automotive. The last, for example, was the truck on which the missile was carried. Each "sub-system" was separately produced and even separately delivered to the Army. But by making one company, in this case A.T. & T.'s Western Electric, the prime contractor, it could collect an overall fee on the whole job, though 75% of the work was done by others. Thus from 1950 to 1962 it took a 7.9% fee on $1.5 billion in Nike orders, or a profit of $112.5 million. But only $359 million of the work was actually performed by Western Electric. So it actually earned $112 million on $359 million, or a sales markup of 31.3%. It is not surprising that from 1951 to 1960, Western Electric's annual rate of return before taxes on average net investment in doing government business was 28.3%. If the Johnson Administration really wants to save money, it might keep the lights turned on at the White House some night and study these figures.

Why They Insisted on Paying Rent

"Much of Western Electric's Nike production was done at two government surplus plants, which under the ordinary method of doing business with the Government would have been supplied to Western Electric without cost. However Western Electric, instead of having the plants supplied free, rented them from the Government. Western Electric included the rentals as part of its overall costs and then charged the Government a profit on these costs. The total rentals paid to the Government by Western Electric for these plants amounted to over $3,000,000. When added to Western Electric's costs, the rentals generated additional profits to the company of $209,000. In such a situation, there could be little resistance on the part of Western Electric to having the Government raise the rent, because as the rent went up, so did Western Electric's profit, since the complete amount of the rent was repaid by the landlord back to the tenant together with a profit."

—Senate Report on Pyramiding Missile Profits.

Western Electric farmed out the aeronautical, automotive and mechanical "sub-systems." But instead of subcontracting them separately, it made Douglas Aircraft the "prime subcontractor" for all three. This gave Douglas a chance to do the same kind of pyramidal padding, and of course the more Douglas padded, the larger the total on which Western Electric took its overall cut. Douglas Aircraft farmed out the mechanical sub-system to U.S. Steel's Consolidated Western Steel, and the automotive sub-system to Fruehauf Trailer. Douglas then turned in a bill to Western Electric for $645 million plus a 7.6% fee or $46 million. Examination by the committee showed that only 17% of this work was done by Douglas. Its real fee was 44.3%.

The committee found similar pyramiding in the bills submitted for the Atlas and Bomarc missiles. General Dynamics/Astronautics earned a 178% fee on the work actually performed by it as prime contractor for the Atlas. Boeing's success in applying the same methods on the Bomarc are indicated by its average annual rate of return to stockholders' equity during the 10 years 1951-60 on government business. This was 74.3% before taxes and 35.6% after, an extraordinary return on risk-free business.

This pyramiding of profits was soon the target of criticism from government auditors. By 1953 the Army's Chief of Ordnance thought millions of dollars might be saved by buying Nike spare parts and components directly. But the civilian secretaries, in what the McClellan committee calls "an unprecedented action" gave Western Electric a veto over such purchases. It graciously consented to allow direct procure-

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ment but only for screwdrivers, pliers, anti-freeze and paper cups!

In negotiating with the missile makers, the Army depends for technical advice on its Missile Command at Redstone Arsenal in Alabama, which theoretically manages 21 missile systems costing more than 2½ billion dollars. "In the 18 years from the time it retained Western Electric," the Army, according to the McClellan report, "has regularly and consistently permitted the competence of its own technical forces at Redstone Arsenal to deteriorate." As a result it has to depend on Western Electric for the facts upon which to make its decisions.

In the Hands of One Army Colonel

As if to make even more sure that it could not bargain effectively, the Army put the bulk of its missile procurement in the hands of one Army Colonel for most of the last ten years, a practice "hardly calculated," the committee observes, "to provide the arms length relationship so essential for proper Government procurement." This Colonel was displeased when an auditor (see box bottom p. 3) called attention to the fact that in one contract Douglas Aircraft was being allowed a total profit of $1.2 million on a total effort of only $3,000. The full amount was paid without question. The Committee notes that the same Colonel is still in charge of contracts with Western Electric and was "distressed to learn from Lt. Gen. John H. Hinrichs, Chief of Army Ordnance, in April 1962 that if production of the multi-billion dollar Zeus [anti-missile] should be ordered" the Army intended to contract the program in the same way through Western Electric.

Instead of eliminating the evils uncovered by these hearings, Secretary McNamara set up ("think-tank" style) a high-sounding Logistics Management Institute, with a board of trustees drawn mainly from the universities, which gave it an academic facade. When we sent a reporter around to find out who actually staffed the Institute, it took two hours of argument before the names were angrily released. It turned out that almost all the staff were from industry, including Douglas, Boeing and General Dynamics. The committee notes sourly that as a result of "reforms" worked out by the Institute the overall fee on the latest Western Electric missile contract went up instead of down.

Unfortunately the committee's recommendations are not as vigorous as its findings. The committee is torn between its observations and its preconceptions. The Nye committee 30 years ago recommended nationalization of the armament business not only to stop profiteering but to end the sinister influence of these "merchants of death" in the councils of government. Today the armament industry *is* nationalized in the sense that most of its work is done in government owned plants with government tools and government funds. But industry runs the show. The committee stultified itself by starting from the premise that "unquestionably this nation's great industrial might is best put to use in producing our weapons when properly motivated toward producing a profit."

Just Helping Small Business

"As a matter of fact I think Douglas Aircraft has an enviable record of subcontracting and supporting the small business program. . . . If reasonable profit earned in the discharge of these responsibilities is to be the subject of criticism, then those of us who are attempting to operate in the spirit of the small business program are being penalized."

—Donald W. Douglas, Jr., pres. Douglas Aircraft, before the McClellan committee, April 4, 1962.

"The Douglas subcontracted work amounted to more than $495,000,000 for Nike production. Its total in-plant effort amounted to less than $103,000,000. More than $209,000,000 of the Douglas out-of-plant effort was in the Fruehauf Trailer and Consolidated Western Steel (a U.S. Steel subsidiary) subcontracts. These two contracts produced profits for Douglas of over $14,000,000. . . . Douglas argues that important assistance to small business rises from substantial subcontracting. The subcommittee fully concurs that a much larger portion of defense work could and should be given to small businessmen, but it hardly considers Fruehauf Trailer and U.S. Steel as small business."

—McClellan Missile Report March 31, 1964 (and see box below on how Douglas helped a small business man).

How Uncle Sam Was Taken For A Ride in A "Redesigned" Nike Missile Truck

"Perhaps the most striking example of savings effected during breakout (the term for breaking a subcontract out of the prime contract and buying directly, to avoid profit pyramiding and to allow competitive bidding—IFS) involved the missile highway transporters. They were designed to carry several Ajax-Nike missiles or parts of the Nike-Hercules missile. The Government had ordered 520 of them from Western Electric. Western Electric subcontracted the job to Douglas Aircraft which in turn sub subcontracted it to Fruehauf Trailer. By the time the 520 trailers were delivered, with the addition of each firm's profits, the trailers bore a price tag of $12,000 each.

"The Government was finally successful in getting permission from Western Electric to procure a quantity of these highway transporters from firms other than Western Electric. It was agreed that some would be procured from Douglas Aircraft, and another lot at the same time directly from Fruehauf Trailer. The price on those bought from Douglas dropped to $10,700; the price on those bought from Fruehauf dropped to $10,300. [Notice that up to this point the contracts had been kept in the same "family" of 3 big firms—IFS.]

"In June 1959 the Government needed another 578 highway transporters. Procurement officials in the Pentagon finally made the decision that this relatively simple trailer could be offered competitively. Bids were sought from various manufacturers throughout the U.S. The winner of the competition was the Henney Motor Co., of Canastota, N.Y., which bid $5,304.31 per unit.

"Shortly after Henney was awarded the contract to produce the 578 trailers, Western Electric made Government funds available to Douglas Aircraft to 'redesign' the highway transporter. . . . Within 6 months after Henney was awarded the contract, the design was so complete that Douglas Aircraft was awarded a contract, in January 1960, to produce 100 of the new transporters. The contract with Henney was terminated after only 266 were produced. Douglas' price for each of the new models was $34,000."

—McClellan report on missile profits. This story had two sequels. The Henney company, which employed 300 to 400 people in its small town area, went out of business. In 1961 a contract for the redesigned truck was put out for competitive bids, and won by a Tulsa concern "which bid $10,000, less than a third of Douglas' price."

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This, of course, is the religion of American business. Who holds to it need not be surprised to see the arms monopolists make off with as big a buck per bang as they can steal.

The Same Racket As in Telephones

The committee's first recommendation is for the President to appoint "a high-level study group to reassess the government's procurement practices." This should be apple-pie for our skillful armament wire-pullers. A convocation of stuffed shirts from our better heeled universities could well end up with a recommendation that the government stimulate private enterprise by paying rent on the Pentagon to A.T. & T. It seems to run the place anyway. Whether one studies the missile business or space contracts or satellite communications, or civilian telephone business, one comes sooner or later on an alliance between A.T. & T. and the Pentagon, with the latter as junior partner. This is what makes the committee's second recommendation so naïve. This is that, maybe, we ought to regulate the arms monopolists as we do the utilities and the telephone business. The committee seems to be unaware of the fact that the system of profit pyramiding in missile procurement resembles the system by which A.T. & T. has long hamstrung regulation of the telephone business. In the contract pyramid, there is no "privity of contract" for the government below the prime contract, i.e., it cannot inquire into or revise the prices paid subcontractors and sub-subcontractors. In much the same frustrating way Federal and State regulatory agencies are unable to look into the prices Western Electric charges the telephone companies for equipment. The more they pay their corporate alter ego, Western Electric, the more they can charge the public for telephone service.

In this connection I would like to call the attention of the FCC, the public utility commissions and the Justice Department to the table at p. 39 of the McClellan report. The purpose of this table was to show that Western Electric takes a lower markup on its sales to the government than on its non-government business, which is almost entirely telephone equipment. But, in the process of showing this, it also disclosed profits on the telephone business much larger than ever suspected before. The table shows that its profits before taxes as a percentage of net investment on its non-government business in the ten years 1951-60 averaged 22.2% a year, and ran as high in one year as 33%. The rate of return supposed

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Boeing Warns Low Profits Imperil Defense

"Serious consideration should be given as to whether the profits now competed for by industry are high enough—high enough, that is, to foster the competition and attract the caliber of management, the technical skills and the capital which will result in the acquisition of the best possible defense equipment at the earliest possible date and for the least total cost. There is great danger to our Nation's continuing ability to protect itself if profits are established at too low a level."

—R. W. Tharrington of Boeing Co. testifying before the McClellan committee investigation of missile profits, May 25, 1962.

Boeing Company Profits on Government Business as a percentage of stockholders equity:

Year	Before Taxes	After Taxes
1960	65.1	31.2
1959	68.3	32.7
1958	74.0	35.5
1957	70.0	33.6
1956	66.3	31.8
1955	64.4	31.0
1954	100.1	48.0
1953	108.6	52.1
1952	91.0	43.6
1951	36.0	17.3
10-Year Average	74.38	35.68

—McClellan Committee Missile Profits Report, Mar. 31.

When An Auditor Went "Out of Line" and Objected to Exorbitant Profits

"This report has given the details of the procurement of a group of Nike launcher loaders. In that case, Douglas Aircraft, with total certified inhouse costs of just over $3,000, was permitted to make a profit of over $1,200,000, while with total certified costs of just over $14,000, Western Electric made almost another $1,000,000 in profit. The actual work was done by the third tier sub-subcontractor Consolidated Western Steel [U.S. Steel]. The subcommittee received in exhibit a Government auditor's report in which he was severely critical of the profit rate being taken by Douglas Aircraft. Col. Graham's * reception of this finding is indeed remarkable:

The Chairman (Sen. McClellan): Here is an audit report that says this fee is not reasonable.

Col. Graham: Sir, it is not normally the responsibility of an Air Force auditor or a Navy cost inspector to comment on fees.

The Chairman: You think he was out of line, then, in making the comment that the fee was not reasonable?

Col. Graham: I do not say he was out of line, sir. I simply say it is normally not part of his responsibility.

The Chairman: He was not censured for doing it, was he?

Col. Graham: I have not any power of censure over the Air Force auditors, sir.

"Col. Graham has auditors, lawyers, price analysts and technical advisers to assist him in arriving at prices that are fair and equitable to the Government:

Mr. [Jerome S.] Adlerman [general counsel, the McClellan subcommittee]: Did this (auditor's report) go through four, five or six boards?

Col. Graham: It went through two boards and my own office.

Mr. Adlerman: And nobody commented on it?

Col. Graham: I can't find any evidence in the file that they did.

"The subcommittee must conclude that something was seriously amiss at the New York Ordnance District when a comment of unreasonableness, containing the shocking figures that it did, would go unnoticed or uncommented upon, through various stages of review, all of which we set up as a result of past congressional investigations in order to close serious drains of Federal funds. . . . It cannot be claimed that this item just slipped through as an unimportant one, because this was a major expenditure in the most important program in the largest Army Ordnance district office."

—McClellan committee report on missile profits.

*** Col. John Wm. Graham, in charge of the New York Ordnance District since 1953; contracting officer on $2 billion of the $2½ billion in contracts awarded to Western Electric on the Nike missile; he "remains to this day as the Army's contracting officer with Western Electric."**

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We Need to Know More About the Missile Monopolists Than Their Profits

to be allowed the telephone monopoly by regulation is between 6 and 7%. This is all it could make on its equipment, too, were it not for the device of putting it in a separate wholly owned corporation, out of regulatory reach.

Corporations may not have souls but they sometimes seem to have a sense of humor. In 1957 there was a conference at Redstone Arsenal to discuss a rising volume of complaint about Western Electric's missile profits. Its vice-president, Fred Lack, pleaded "that Western is regulated by the Public Utility Commission [sic], who constantly look over their shoulders. If the Government profits were reduced, the Commission might suggest that telephone profits be reduced." We had to go on paying more for missiles so we could go on being charged more for telephone calls.

The Military and Anti-Trust

It is a pity there is no other committee of Congress to take up the task of investigation where the McClellan committee left off and look into the influence of A.T. & T. on the missile race itself. Its influence in other spheres is documented, if not widely known. Senator Long of Louisiana, in the unsuccessful filibuster against the communications satellite bill put the whole story into the Congressional Record on August 17, 1962. He asked the Senate then, "Is the Department of Defense a secret arm of the American Telephone & Telegraph Company?" For 30 years the Pentagon has helped A.T. & T fight off attempts to break up the Western Electric combination and force competition in telephone equipment. The military bureaucracy tried to prevent Attorney General Clark from filing an anti-trust suit for this purpose in the Truman Administration and it helped A.T. & T. defeat the suit with a consent decree in the Eisenhower Administration. The Pentagon went so far as to slip private government memoranda to A.T. & T. when a House committee under Celler investigated this whole sellout.

As far back as the years before the first World War, parliamentary investigations in Germany and England began to expose the role played by arms makers in fomenting tension, suspicion and war. A corporation like A.T. & T. is a faceless private collectivity cranked up for one purpose only and that is profit. It is as intrinsically un-moral as an IBM machine. What part did it and other missile makers play in the fake missile gap hysteria before the 1960 elections? In the decision to go ahead and build a stupefying total of some 1200 missiles even after the gap was found to be non-existent? In the plan for a $5 billion dollar multilateral missile force in NATO, which has the additional advantage to the missile monopoly of blocking disarmament negotiations? What is their influence in the Pentagon now that we stand at a fateful crossroads? Down one road lies relaxation of tension and a minimum missile deterrent. Down the other lies a $20 billion anti-missile program which will raise the arms race and tension to new heights and force our cities to begin to move underground in vast blast shelters. We ought in self-defense to know more about A.T. & T. and General Dynamics and Boeing than their profits.

Multi-Million Dollar Free Ride Dept.

"Figures were introduced by the subcommittee staff showing Douglas Aircraft profits of $63,800,000. Donald Douglas testified that the corporate profits were only $34,000,000 before taxes, if consideration was given to costs unreimbursed under the contracts. Attempts were made during the hearings to get a breakdown on the apparent discrepancy between subcommittee figures and Douglas figures. Douglas insisted that the disallowed costs were specifically assignable to the Nike contracts. . . .

"The hearings on the Nike program ended on April 18, 1962. On April 27, 1962, the chairman received from Douglas the requested breakdown of the $34 million. The subcommittee learned to its amazement that Mr. Douglas claimed that the $34,000,000 discrepancy consisted of more than $23,000,000 in costs incurred in the development of the DC-8 commercial jet airliner, that more than $1,000,000 additional related to costs incurred in developing the DC-7 commercial aircraft, the DC-6 commercial aircraft, and even the DC-3 commercial aircraft. The latter was a pre-World War II airplane."

—McClellan Report on Missile Profits.

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